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In the Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA, PETITIONER

v.

THE GOODYEAR TIRE & RUBBER COMPANY AND AFFILIATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES

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58

QUESTION PRESENTED

Whether the term "accumulated profits" in the foreign tax credit provisions of Section 902 of the Internal Revenue Code means income or profits as defined by the tax law of the United States or, instead, as defined by the tax law of a foreign country.

TABLE OF CONTENTS

Argument—Continued: Page

TABLE OF AUTHORITIES

Cases:

Cases—Continued: Page

Statutes and regulations:

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-8a) is reported at 856 F.2d 170. The opinion of the Claims Court (Pet. App. 9a-28a) is reported at 14 Cl. Ct. 23.

JURISDICTION

The judgment of the court of appeals (Pet. App. 29a) was entered on August 31, 1988. A petition for rehearing was denied on November 8, 1988 (Pet.

App. 31a). On January 25, 1989, the Chief Justice extended the time within which to petition for a writ of certiorari to and including March 8, 1989. The petition was filed on that date, and was granted on May 1, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Sections 316, 901, and 902 of the Internal Revenue Code of 1954 (26 U.S.C.) and Section 1.902-3 of the Treasury Regulations on Income Tax (26 C.F.R.), as in effect for 1970 and 1971, are set forth in pertinent part in a statutory appendix (App., *infra*, 1a-4a).

STATEMENT

1. This case involves the foreign tax credit applicable to the federal taxation of dividend income received by a United States corporation from its foreign subsidiary. When a foreign subsidiary distributes all or part of its profits to its domestic parent, that distribution generally is taxable to the parent as a dividend under the provisions of Sections 301 and 316 of the Internal Revenue Code.[1] If those profits have already been subjected to income tax by the foreign country where they were earned, simple taxation as a dividend by the United States would result in double taxation.[2] Accordingly, Sections

[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect during 1970 and 1971, the years at issue (the Code or I.R.C.).

[2] The deduction for intercorporate dividends allowed by Section 243 of the Code is applicable only to dividends received from domestic corporations.

901(a) and 902(a)(1) of the Code allow the parent (if it owns at least 10% of the voting stock of the foreign subsidiary) to take an "indirect" or "deemed paid" credit against its United States income tax to reflect income tax paid by the subsidiary to a foreign country.

The situation is complicated somewhat when, in a particular year, the foreign subsidiary does not distribute all of its profits to its parent, but instead retains some of the profits and adds them to surplus. In that event, giving the parent a full credit for all of the foreign income tax paid by the subsidiary would overcompensate for the double taxation risk—and thus give the taxpayer a windfall—because the parent is not receiving all of the subsidiary's profits as a dividend subject to United States income tax. Therefore, the Code allows the parent to take a credit against the income tax payable to the United States for only a prorated portion of the foreign income taxes paid by the subsidiary. See generally *American Chicle Co.* v. *United States*, 316 U.S. 450 (1942).

Section 902(a)(1) provides for the computation of the allowable credit as follows: "to the extent such dividends are paid by such foreign corporation out of accumulated profits," the parent is "deemed to have paid the same proportion of any income * * * taxes paid * * * by such foreign corporation to any foreign country * * * on or with respect to such accumulated profits, which the amount of such dividends * * * bears to the amount of such accumulated profits in excess of such * * * taxes." In other words, the allowable prorated credit is computed by multiplying the foreign income taxes paid by a fraction—namely, the ratio of the dividends to the subsidiary's (after-tax) accumulated profits. This computation

is illustrated by the following equation (see Pet. App. 4a, 15a n.6):[3]

$$\text{Foreign taxes paid} \times \frac{\text{Dividends}}{\text{Accumulated profits minus foreign taxes}} = \S\,902 \text{ credit}$$

The issue in this case is the meaning of the term "accumulated profits"—specifically, whether it refers to the subsidiary's profits as computed under United States tax law or under the tax law of the foreign country.[4]

[3] This Court described this equation in narrative form in *American Chicle*, stating that the foreign taxes are multiplied by a fraction, of which "[t]he numerator is the dividends received by the parent [and] [t]he denominator is the 'accumulated profits' of the subsidiary" (316 U.S. at 452); the statute was later amended to require the subtraction of foreign taxes from the denominator (see note 10, *infra*). The operation of the proportional credit can be illustrated by some simple examples. If a foreign subsidiary earns $100 of profits, pays $20 in foreign income taxes and distributes the remaining $80 to its parent as a dividend, the parent is entitled to the full $20 credit ($20 × $80/($100-$20)). If, however, the subsidiary distributes only $40 of its after-tax profits to its parent, the allowable credit will be halved to $10 ($20 × $40/($100-$20)). The allowable credit can also be affected by a change in the denominator of the fraction. If the subsidiary pays the same $20 in foreign income taxes and distributes the same $80, but the "accumulated profits" are determined in a different manner and found to be $180, the allowable credit will also be halved to $10 ($20 × $80/($180-$20)).

[4] The statutory definition of "accumulated profits" does not specifically address this question. It defines the term for purposes of Section 902 as "the amount of [the corporation's] gains, profits, or income computed without reduction by the amount of the income * * * taxes imposed on or with respect to such profits or income" (I.R.C. § 902(c)(1)). The definition further provides that the Commissioner has the "full power to determine from the accumulated profits of what year or years such dividends were paid," generally "treating dividends as having been paid from the most recently accumulated gains, profits, or earnings" (*ibid.*). The credit thus is computed by considering the subsidiary's accumulated profits on an annualized basis. A dividend payment is allocated first to the accumulated profits of the most recent year and then, if those profits are insufficient to cover the amount of the dividend, to the profits of the next most recent year, and so forth. The credit is then computed separately for each year to which the dividend is traced (or "sourced") by multiplying the foreign income tax paid for that year by the appropriate fraction. The sum of those separate annual computations yields the Section 902 credit for the particular dividend. See *H.H. Robertson Co.* v. *Commissioner*, 59 T.C. 53, 78-83 (1972), aff'd, 500 F.2d 1399 (3d Cir. 1974); *General Foods Corp.* v. *Commissioner*, 4 T.C. 209, 215 (1944).

2. Respondent is an affiliated group of domestic corporations that file consolidated federal income tax returns. The parent of the group (Goodyear U.S.) owns all of the stock of a British subsidiary (Goodyear U.K.) that does not join in the consolidated return. The subsidiary reported net income on its British tax returns for 1970 and 1971, paid taxes to Britain on that income, and distributed dividends to its parent. On the United States consolidated tax returns for 1970 and 1971, respondent claimed Section 902 foreign tax credits with respect to the foreign tax paid for those years by the British subsidiary. On its 1973 British tax return, however, the subsidiary reported a loss (attributable to accelerated depreciation and special inventory adjustments), which it carried back to offset virtually all of its income for 1971 and part of its income for 1970. As a result of this loss carryback, Britain refunded almost all of the income tax paid for 1971 and part of the tax paid for 1970. The 1973 loss deductions, although

recognized under British law, would not be allowable in computing income under the Internal Revenue Code. Pet. App. 1a-2a, 10a-11a.

Following the payment of the British tax refunds, the Commissioner audited respondent's consolidated returns for 1970 and 1971 and recomputed the foreign tax credits under the authority of Section 905(c) of the Code, which requires the redetermination of a foreign tax credit after a refund of any of the foreign tax paid. The Commissioner reduced the creditable foreign taxes to reflect the refund, but made no adjustment to the British subsidiary's "accumulated profits," which he determined must be computed under principles of United States tax law and therefore were unaffected by the 1973 loss and resulting carryback not allowable under the Internal Revenue Code. Under this analysis, the subsidiary's profits for 1970 and 1971 were adequate to cover the dividends paid in those years, and the Commissioner treated the dividends as having been derived from the accumulated profits for the years of distribution. Because the foreign tax paid in those years (after taking into account the refund) was relatively small, the Section 902 credit for those years allowed by the Commissioner was correspondingly small. He asserted deficiencies in respondent's income tax of $323,654 for 1970 and $237,616 for 1971. Pet. App. 2a-3a & n.3, 11a-12a, 23a-24a.

Respondent paid the deficiencies and, after its administrative refund claim was denied, brought this refund action in the Claims Court. It contended that, for purposes of computing the prorated credit, the "accumulated profits" must be based on the British definition of taxable income. Respondent therefore adjusted that figure to account for the loss carryback peculiar to British law. This adjustment

eliminated almost all of the subsidiary's accumulated profits for 1971 and reduced them for 1970. The result was a substantially larger Section 902 credit for respondent for 1970 and 1971, and therefore a correspondingly smaller United States income tax liability, than when the Commissioner had computed "accumulated profits" based on the United States definition of taxable income. Pet. App. 3a, 15a-16a.[5]

3. On cross-motions for summary judgment, the Claims Court held for the government, ruling that "accumulated profits" in Section 902 means income or profits as defined by the Internal Revenue Code, not by the tax law of a foreign country (Pet. App. 9a-28a). The court found that this conclusion was strongly supported by Tax Court precedent (*id.* at 16a-19a) and by the language (*id.* at 19a-21a), purpose (*id.* at 22a-25a), and consistent administrative interpretation (*id.* at 25a-26a) of Section 902. With respect to the statute itself, the court explained that the dividends in the numerator of the Section 902 fraction are undeniably computed under United States law (Pet. App. 20a) and that the "accumulated profits" in the denominator are "the fund from

[5] The tax advantage was achieved by respondent in two related ways. First, the reduction in accumulated profits in 1970 correspondingly increased the ratio of dividends to profits for that year, thereby allowing respondent to take a credit for a higher proportion of the 1970 British tax. Second, because the accumulated profits for 1971 were virtually eliminated, those profits were not sufficient to cover the dividend paid in that year. Accordingly, under the annualization principle of Section 902 (see note 4, *supra*), part of the 1971 dividend was attributed to profits earned in preceding years going back to 1968. Because the foreign taxes for those years were much higher than the almost nonexistent tax of 1971, respondent's allowable Section 902 credit was increased. Pet. App. 23a-24a; J.A. 30.

which the dividends are paid" (*id.* at 21a). Therefore, the court concluded, it would introduce an inconsistency that would impair the proper functioning of the allocation formula if United States law is not also used to compute the profits in the denominator (*ibid.*).

Based on the legislative history, the Claims Court identified three principal purposes of the Section 902 credit: (1) to provide equal treatment for unincorporated foreign branches and foreign subsidiaries; (2) to eliminate double taxation; and (3) to limit the allowable credit for foreign taxes paid by a subsidiary when only a portion of its profits is distributed as a dividend. Pet. App. 23a. The court found that its interpretation "effectuates congressional intent" (*ibid.*) in furthering these policies, whereas respondent's interpretation would frustrate them. In particular, the court rejected respondent's contention that defining "accumulated profits" in terms of United States law would lead to double taxation in this case. The court explained that the relatively small credit that respondent receives under the court's interpretation is a direct result of the fact that its subsidiary paid very little British income tax for 1970 and 1971. *Id.* at 24a. The court concluded (*ibid.*): "To not recognize this fact as [respondent] urges would eviscerate the very purpose of the pro-rata credit and permit [respondent] a substantial windfall in avoiding other taxes with the phantom taxes deemed paid."

Finally, the court found that its holding was supported by the longstanding administrative construction embodied in Treas. Reg. § 1.902-3(c)(1) (1971 ed.). That regulation explicitly defines the phrase "accumulated profits" in Section 902 in terms of

"earnings and profits," which are the source of dividends under Section 316 of the Code and which are computed under United States law. The court concluded that this administrative construction is "consistent with the purposes enunciated by Congress when enacting the indirect tax credit legislation" (Pet. App. 26a).

4. The court of appeals reversed (Pet. App. 1a-8a). The court held that the "plain meaning" of Section 902 requires the conclusion that "accumulated profits" be determined by applying the tax law of the foreign country (*id.* at 6a). The court stated that the text of Section 902(a)(1) describes the creditable foreign taxes as those paid "on or with respect to the accumulated profits of such foreign corporation," and that Section 902(c) uses similar language (Pet. App. 5a (quoting the 1982 version of Section 902) (emphasis omitted)). The court concluded from this phrasing that "accumulated profits" must be "the actual basis on which the foreign sovereign assesses tax liability," *i.e.*, foreign taxable income as determined by foreign revenue laws (*id.* at 6a). The court also concluded that its interpretation is necessary to implement the statutory goal of preventing double taxation, stating that determining "accumulated profits" under United States law would defeat this goal by "severing the relationship" between the foreign taxes paid by the subsidiary and the accumulated profits with respect to which those taxes are paid (*ibid.*). The court rejected the Tax Court precedent relied upon by the Claims Court as "fail[ing] to address the controversy raised in the instant case" (*id.* at 7a), and it did not discuss at all the Treasury Regulation that defines "accumulated profits" under Section 902 in terms of "earnings and profits."

SUMMARY OF ARGUMENT

A. The basic function and purpose of Section 902 are to avoid double taxation by allowing the domestic parent of a foreign subsidiary a foreign tax credit on its United States income tax return. This indirect credit is designed to reflect the foreign tax already paid by the subsidiary on the portion of its income that is distributed as a dividend to the parent. When all of the income of the subsidiary is so distributed, the parent should be entitled to a credit for all of the foreign tax paid. When only a portion is so distributed, however, and the rest is retained by the subsidiary as surplus, the Section 902 apportionment formula is intended to limit the credit to the portion of the foreign tax paid that is attributable to the distributed earnings—those "paid * * * out of accumulated profits." For this apportionment to work properly, the statutory ratio ("dividends" to "accumulated profits" less foreign taxes) must reflect the ratio between the actual dividends paid and the pool of potential dividends, *i.e.*, the maximum earnings of the foreign subsidiary that would be taxed as dividends if distributed to the parent.

Dividends are defined as distributions paid out of "earnings and profits," and it is well settled that the term "earnings and profits" is defined by principles of United States law (see I.R.C. §§ 312, 316). Therefore, the pool of potential dividends contained in the Section 902 apportionment formula (*i.e.*, "accumulated profits") must be defined in terms of United States tax principles. Indeed, the unworkability of the Section 902 apportionment formula under the court of appeals' interpretation is further shown by the fact that, if "accumulated profits" are defined in terms of foreign law principles to be higher than

under United States rules, the parent typically would not be allowed the full credit in cases where the subsidiary distributes its entire pool of potential dividends. In short, the use of United States law to determine "accumulated profits" is required to correlate the numerator of the Section 902 fraction (the actual dividends) with the denominator of the fraction (the potential dividends), thereby providing a coherent ratio by which to determine the foreign tax that relates to the distributed portion of the subsidiary's total earnings.

B. One of the dominant concerns motivating Congress in its enactment, and later revisions, of the indirect credit of Section 902 has been the desire to provide domestic corporations that operate through a separately incorporated foreign subsidiary with the same relief from double taxation as is provided to companies with an unincorporated foreign branch. That statutory policy would be seriously undermined by the interpretation of the court of appeals. A foreign branch has no separate tax status and therefore a domestic company with a foreign branch is required to report all of the branch's income on its United States tax return. It is then granted a "direct" credit by Section 901 for foreign taxes paid with respect to that income. Foreign concepts of taxable income have no bearing on whether the earnings of the branch are recognized on the return of the domestic "parent"; those earnings, like any other earnings of the parent, are included in its income according to United States principles of taxation. To maintain the tax treatment of the two types of business arrangements on an equal footing, the accumulated profits of a foreign subsidiary must approximate the income that would be reported by the parent were it conducting operations

through a branch. Otherwise, the two arrangements will yield different treatment even where a subsidiary distributes all of its available earnings and profits as a dividend (which is essentially equivalent to the direct attribution of income to the domestic company in the branch situation). Thus, the "accumulated profits" of a foreign subsidiary must be computed under United States law, just like the income of a foreign branch.

C. The Treasury has consistently ruled that "accumulated profits" in Section 902 are computed according to United States tax principles. This reading of the statute was first contained in a ruling issued in 1933, and it was embodied in a formal regulation in 1965. Considerable deference is due to this longstanding administrative interpretation, which also has been approved by the Tax Court for many years and by Congress when it amended Section 902 in 1986. Moreover, this interpretation accords with the general principle that, in the absence of an express indication to the contrary, Congress intended that provisions of the Internal Revenue Code would be construed under United States law rather than under unfamiliar and highly variable concepts of foreign law. See *Biddle* v. *Commissioner*, 302 U.S. 573 (1938).

D. The court of appeals' reliance on the "plain meaning" of Section 902 is erroneous. The clause on which the court rested its analysis was designed to make clear that the foreign taxes that are the starting point for computing the credit are those paid with respect to the income of the subsidiary actually available for distribution as dividends. Thus, this clause suggests that "accumulated profits" should accord with "earnings and profits," which are defined in

terms of United States law. Moreover, the statutory phrase "dividends * * * paid * * * out of accumulated profits" also suggests identification of the term "accumulated profits" with the pool of potential dividends determined under United States law. Accordingly, there is no "plain meaning" of Section 902 that supports the court of appeals' interpretation.

Nor does that interpretation advance the statutory policy of preventing double taxation. The fact that respondent's credit on its 1970 and 1971 tax returns is reduced when "accumulated profits" are determined under United States law is a logical consequence of the fact that respondent's subsidiary paid little foreign tax in those years as a result of the loss and carryback available only under British law. Because most of the "earnings and profits" distributed by the subsidiary had escaped British tax owing to the loss carryback, they were taxed *for the first time*, not the second, when included in respondent's United States income. By contrast, respondent seeks a substantial windfall through ignoring these untaxed profits and instead treating the dividends in question as distributions of profits earned in prior years when the subsidiary paid higher taxes to Britain—profits that had yet to be distributed to respondent under the principles of Sections 312 and 316 of the Code.

ARGUMENT

THE TERM "ACCUMULATED PROFITS" IN SECTION 902 OF THE CODE MEANS INCOME OR PROFITS AS DEFINED BY THE TAX LAW OF THE UNITED STATES, NOT AS DEFINED BY THE TAX LAW OF A FOREIGN COUNTRY

Section 902 of the Code specifies the amount that a United States corporation may credit against its United States income tax for foreign taxes paid by its subsidiary. The court of appeals in this case held that the term "accumulated profits" in that provision of the United States tax laws must be defined in terms of the tax law of the foreign country. This counterintuitive conclusion—reached without any recognition by the court of its inconsistency with a long-standing administrative interpretation and a Treasury Regulation directly in point—is antithetical to the basic design of the statute and undermines its purposes.

Section 902 computes the allowable foreign tax credit by allocating the foreign tax paid to the portion of the foreign-sourced income that is being reported on the United States income tax return. This allocation is based on the ratio between the dividends received by the domestic parent and the "accumulated profits" of the subsidiary from which the dividends are paid. The amount of "dividends" to be included in the income of the United States parent is determined by United States tax law; it depends in the first instance upon the existence and amount of the subsidiary's "earnings and profits" as determined by Section 312 of the Code, and then upon the extent to which the distribution was paid out of those "earnings and profits" as determined under Section 316. The logic of the statutory allocation formula is destroyed, however, if United States law is used to measure the dividends, but foreign law is used to compute the "accumulated profits" of the subsidiary out of which the dividends are paid; moreover, the use of such an unbalanced ratio would lead to irrational results and disparities not intended by Congress.

The decision below also undermines the statutory goal of avoiding discrimination between domestic companies that operate abroad through unincorporated foreign branches and those that operate through separately incorporated foreign subsidiaries. Since the profits of a foreign branch are determined under United States law, the accumulated profits of a foreign subsidiary must be similarly computed in order to provide the domestic companies with the same relief from double taxation regardless of the manner in which they operate their foreign business. Thus, the decision of the court of appeals is erroneous and would significantly disrupt the proper operation of the foreign tax credit provisions of the Internal Revenue Code.

A. Because The Dividends Taken Into The Income Of The United States Parent Are Defined In Terms Of United States Tax Principles, The Term "Accumulated Profits" In Section 902 Must Also Be Defined In Terms Of United States Law In Order To Make The Statutory Allocation Formula Coherent

1. *"Accumulated Profits" Describes the Fund out of Which the Dividends Reported as United States Income Are Paid*

The term "accumulated profits" was introduced into the ratio for computing the indirect foreign tax credit by Section 238(e) of the Revenue Act of 1921, ch. 136, 42 Stat. 259. This Act was designed to cor-

rect a major flaw in the original indirect foreign tax credit provisions contained in Section 240(c) of the Revenue Act of 1918, ch. 18, 40 Stat. 1082. The 1918 statute computed the credit based on the ratio of the dividends received by the domestic company to the foreign subsidiary's "total taxable income" for that year. This provision failed to achieve its purpose of relieving double taxation in cases where the profits of a foreign subsidiary were distributed in a different year from that in which they were earned. For example, if the subsidiary made no profit and paid no foreign tax for a particular year, yet issued a dividend out of surplus accumulated during a prior year for which it had paid a foreign tax, the 1918 statute would not have allowed any credit because there was no foreign tax paid in the year of the distribution. The statute contained no mechanism to attribute or "source" the dividend to the prior year's accumulated earnings or to provide a credit for tax paid in other years on the profits that were the source of the dividend. As this Court explained in *American Chicle Co.* v. *United States*, 316 U.S. 450, 453 (1942), "[t]he difficulty with [the statute] was that it did not relate the credit to the accumulated profits or surplus of the subsidiary *out of which the dividends were paid*" (emphasis added).

Thus, in amending the statute in 1921, Congress needed to describe the total earnings of the foreign corporation, past and current, which are the source from which dividends can be declared, and then to allow a credit for the foreign taxes already paid upon the distributed portion of those earnings. To accomplish this, Congress chose the term "accumulated profits," an ordinary accounting term that includes earnings of prior years as well as current earnings,

and substituted it for "total taxable income" throughout the statute. As a result, the amended provision described the creditable foreign taxes as those "paid * * * upon or with respect to the accumulated profits * * * from which such dividends were paid," and it directed computation of the credit by multiplying those foreign taxes by the ratio of the "dividends" to the "accumulated profits." Sec. 238(e), 42 Stat. 259. The statute thus established a two-step process for determining the allowable credit: first, the maximum credit is fixed by ascertaining the foreign taxes paid upon the pool of profits that are the potential source of dividends; second, the allowable credit is limited to the proportion of the maximum credit that the dividends actually distributed bear to the total pool of profits.[6] The result of this process is a credit in the amount appropriate to prevent double taxation of the dividends received. In the words of this Court, the statute was designed "to permit identification of the accumulated profits of each taxable year out of which the dividend might have been paid and to give credit for a proportion of the subsidiary's taxes attributable to such accumulated profits." *American Chicle Co.* v. *United States*, 316 U.S. at 454.

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[6] As we have stated (see note 4, *supra*), this matching of the dividends to the accumulated profits is done on a year-by-year basis. The 1921 statute vested the Commissioner with full power "to determine from the accumulated profits of what year or years such dividends were paid," generally "treating dividends as having been paid from the most recently accumulated gains, profits, or earnings." That authority was continued unchanged in the version of the statute applicable here. See I.R.C. § 902(c)(1).

The essential features of the 1921 statute have been carried forward into the foreign tax credit provisions of Section 902 applicable here. The statute permits a domestic company to claim a prorated credit with respect to dividends received from a foreign subsidiary "to the extent such dividends are paid by such foreign corporation out of accumulated profits" (I.R.C. § 902(a)(1)). The basic apportioning fraction remains the ratio of "dividends" to "accumulated profits," and the accumulated profits continue to represent the fund of earnings, current and historic, from which the dividends are paid. As the Tax Court explained in *H.H. Robertson Co.* v. *Commissioner*, 59 T.C. 53 (1972), aff'd, 500 F.2d 1399 (3d Cir. 1974), the credit is allowed "in respect of foreign taxes paid on the 'accumulated profits' of a particular year to the extent that dividends are paid 'out of' the accumulated profits of such year" (59 T.C. at 87-88). The statute thus designates the accumulated profits as the "source" of the distributions by the subsidiary that are taxed in the United States as dividends to the parent (see *id.* at 87 n.19).

2. ***The Apportionment Formula of Section 902 is Incongruous unless "Accumulated Profits," like Dividends, Are Determined under Principles of United States Law***

Section 316 of the Code provides that distributions to shareholders from a corporation's "earnings and profits" are "dividends"; if a distribution exceeds the available "earnings and profits," however, the excess is not a dividend but rather a return of capital (I.R.C. § 301(c)). Section 312 of the Code, in turn, provides a detailed set of rules that govern the computation of "earnings and profits."[7] When a foreign subsidiary makes a distribution to its domestic parent, as in this case, it is fundamental that these provisions of United States law apply to the earnings and profits of the foreign corporation to determine the extent to which that distribution is to be treated as a "dividend" to the parent for United States tax purposes.[8] See, *e.g.*, *Untermyer* v. *Commissioner*, 24 B.T.A. 906 (1931), aff'd, 59 F.2d 1004 (2d Cir.), cert. denied, 287 U.S. 647 (1932).

It is similarly clear that the term "dividend" in Section 902 must be defined in the same manner, *i.e.*, that the amount of the dividend used in the apportionment formula is the same as that reported by the parent as dividend income under the rules of Sections 312 and 316. See Treas. Reg. § 1.902-1 (a)(6); see also, *e.g.*, *H.H. Robertson Co.* v. *Com-*

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[7] This Court has addressed the complexities of the computation of earnings and profits on several occasions. See *Commissioner* v. *Phipps*, 336 U.S. 410 (1949); *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496 (1948); *Commissioner* v. *Munter*, 331 U.S. 210 (1947); *Commissioner* v. *Wheeler*, 324 U.S. 542 (1945); *Foster* v. *United States*, 303 U.S. 118 (1938); *Helvering* v. *Canfield*, 291 U.S. 163 (1934); *Mason* v. *Routzahn*, 275 U.S. 175 (1927).

[8] For example, if a foreign subsidiary earned $500 in "earnings and profits" and distributed that $500 to its domestic parent, the parent would recognize $500 in dividend income on its United States return. If the foreign country allowed a $500 deduction not available in the United States and therefore the subsidiary's profit computed under foreign law was zero, that would not change the treatment on the parent's United States income tax return. Because the $500 distribution came out of "earnings and profits" as defined in the Internal Revenue Code, it would be a dividend, not a return of capital, regardless of the foreign country's definition of income.

missioner, 59 T.C. at 86; *Central Aguirre Sugar Co.* v. *Commissioner*, 24 T.C. 630, 636-638 (1955); *National Carbon Co.* v. *Commissioner*, 2 T.C. 57, 61 (1943). The intent of the indirect credit is to prevent double taxation of the "dividends" that the domestic parent receives from the subsidiary and must treat as taxable on its United States return. Therefore, the foreign tax must be apportioned to the domestic parent based on the amount of those dividends. This can be accomplished only if the term "dividends" in the numerator of the Section 902 fraction has the meaning assigned to it by Section 316 of the Code, which depends on the corporation's "earnings and profits." In sum, the phrase "dividends * * * paid * * * out of accumulated profits," which describes the numerator of the apportionment fraction in Section 902(a)(1), must be read in the same way as the phrase "distribution of property * * * out of its earnings and profits" in Section 316; it is defined solely in terms of United States law.

The Claims Court thus correctly concluded that the use of foreign law to define accumulated profits would destroy the "[al]gebraic consistency" of Section 902 (Pet. App. 21a) and would prevent the statute from working properly to eliminate double taxation. As we have explained, the concept of "accumulated profits" was introduced into the predecessor of Section 902 to represent the source of the dividend payments that are being subjected to United States income taxation. Thus, the "accumulated profits" in the denominator of the Section 902 fraction, like "earnings and profits," simply represent the fund of earnings, past and present, out of which the dividends are paid. The total accumulated profits form a pool of potential dividends, *i.e.*, the maximum

earnings of the subsidiary that would be taxed as dividends if distributed to the parent. The allocation formula is designed to limit the credit according to the proportion of those total profits that are actually distributed as dividends. Just as United States tax principles determine whether the subsidiary's actual distribution is taxed as a dividend in the hands of the parent, so too United States tax principles must determine what is the maximum amount of the subsidiary's earnings that could be distributed as a dividend, *i.e.*, the "accumulated profits." It is therefore necessary that "accumulated profits" be determined under principles of United States law in order to correlate the numerator of the Section 902 fraction (the actual dividends) with its denominator (the potential dividends), and thereby provide a coherent ratio by which to compute the share of foreign tax that relates to the distributed portion of the subsidiary's total income.

The ways in which the court of appeals' interpretation of Section 902 would disrupt—indeed, distort—the proper functioning of the credit can be illustrated by the simple examples provided above (see note 3, *supra*). If the foreign subsidiary earns \$100 of profit for the taxable year (as determined under the Internal Revenue Code), pays foreign tax of \$20 for the year, and distributes its net profit of \$80 to its domestic parent as a dividend, the parent is entitled to the full \$20 credit (\$20 x \$80/(\$100 - \$20)). This result is obviously correct; when the subsidiary distributes to the parent all of the funds available for dividends, *i.e.*, its entire net profit, the parent should be entitled to a credit for all of the foreign taxes paid. This result is achieved, however, only if "accumulated profits" are defined under United States

law. If, on the same facts, the foreign country does not allow an $80 deduction that is permitted by United States law and therefore the "accumulated profits" determined under foreign law would be $180, application of the court of appeals' interpretation would halve the parent's credit to $10 ($20 x $80/($180-$20)), even though the parent took into income 100% of the amount of earnings available for distribution as a dividend. Similarly, if the foreign country allows a $40 deduction that is not allowed by United States law and if the subsidiary distributes only $40, the parent would be entitled to the full amount of the available credit ($20 x $40/($60-$20)), even though it received (and was being taxed upon) only half of the subsidiary's net earnings available for dividend distribution with respect to that year's operations. Thus, the court of appeals' approach, in attempting to apportion the credit without consideration of the fund of potential dividends out of which the distribution is made, would reintroduce the very kind of "eccentric results" that the 1921 legislation was designed to eliminate (see *American Chicle Co.* v. *United States*, 316 U.S. at 453).[9]

The above analysis is supported by this Court's holding in *American Chicle* itself. The Court there

[9] See 1 E. Owens & G. Ball, *The Indirect Credit* 162 (1975):

> After all the profits of a year have been distributed, the quantity used in the numerator of the fraction, "dividends," must be the same as the amount used in the denominator, "net profits." Otherwise, the amount of indirect credit will be either more or less than the amount of the foreign tax actually paid. In short, the section 902 allocation fraction functions properly only when the definition of dividends (aggregate) and net profits is exactly the same.

construed the very phrase upon which the court of appeals relied (see Pet. App. 6a)—taxes "paid * * * with respect to the accumulated profits" of the subsidiary (see 316 U.S. at 451). At that time, the predecessor of Section 902 defined "accumulated profits" as after-tax profits. The question presented was not the meaning of that term, but rather the meaning of the entire "taxes paid" clause—whether the foreign tax that is the starting point for computing the credit should be the total tax paid on the subsidiary's pre-tax profits or instead a smaller amount reflecting the proportion of total tax attributable to the after-tax profits. The Court agreed with the government that Congress had intended the latter result.[10] The Court explained (*id.* at 452-453):

[10] The precise dispute in *American Chicle* can be illustrated by an example. If the subsidiary had $200 in income and paid foreign tax of $20, it would have had $180 in "accumulated profits" as then defined. If the subsidiary had distributed the $180 as a dividend, the taxpayer's position in *American Chicle* was that it would be entitled to a $20 credit. The Court rejected that position, however, finding that $20 was the amount of taxes paid on the subsidiary's pre-tax income, not the amount paid "with respect to the accumulated profits" of $180. Thus, under the so-called *American Chicle* limitation, the taxpayer was entitled to a credit of only $18, the foreign tax apportionable to the $180 of accumulated profits.

In 1962, Congress amended Section 902 to accomplish a similar result by redefining "accumulated profits" as the pre-tax income of the subsidiary, but at the same time adding Section 78 of the Code, which requires the parent to take into income ("gross-up") the amount of the allowable foreign tax credit. Under that approach, applicable for the tax years at issue in this case, the credit is first computed without the *American Chicle* limitation, but this change is offset by treating the credit itself as income to the parent. See, *e.g.*, *H.H. Robertson Co.* v. *Commissioner*, 59 T.C. at 77 & n.13. Con-

If, as is admitted, the purpose is to avoid double taxation, the statute, as written, accomplishes that result. The parent receives dividends. Such dividends, not its subsidiary's profits, constitute its income to be returned for taxation. The subsidiary pays tax on, or in respect of, its entire profits; but, since the parent receives distributions out of what is left after payment of the foreign tax,—that is, out of what the statute calls "accumulated profits," it should receive a credit only for so much of the foreign tax paid as relates to or, as the Act says, is paid upon, or with respect to, the accumulated profits.

The lesson of *American Chicle* is that the benchmark for computing the prorated Section 902 credit is the maximum amount of the subsidiary's earnings available for distribution as dividends. Amounts that are not available for distribution as dividends are not relevant in making the proration. Thus, in *American Chicle*, the amount of the subsidiary's earnings paid as foreign taxes would never be available for distribution as dividends; hence, the amount of foreign tax attributable to those earnings was not creditable. Correspondingly here, the amount of the sub-

gress otherwise intended no change to the applicable apportioning fraction under Section 902. As both the House and Senate Reports on the 1962 Act make clear, "[t]he result is to continue * * * the use of the ratios under existing law, but because of the amendment * * * the amount against which the ratios operate is increased [by removing the *American Chicle* limitation]." H.R. Rep. No. 1447, 87th Cong., 2d Sess. A79-A80 (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 223 (1962). This adjustment was necessary to achieve maximum parity between the tax treatment of foreign branches and foreign subsidiaries. See pp. 26-32, *infra*; B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 17.11, at 17-45 to 17-47 (5th ed. 1987).

sidiary's income computed under foreign law principles does not define the maximum amount available for distribution as a dividend. To the extent the income under foreign law differs from that calculated under United States law, the difference has no bearing on the maximum amount of earnings that would be taxed as a dividend upon distribution to the parent in the United States. It is that figure, the "earnings and profits" of the subsidiary as computed under United States law, that logically must be the point of reference for determining the allowable portion of the credit.[11]

In sum, the statutory design is that the allowable credit shall be the proportion of the foreign tax that the dividends actually received bear to the potential dividends. That approach confines the credit to the amount necessary to prevent double taxation. It can be implemented only if "accumulated profits" are computed under United States law so that they equal the fund of potential dividends out of which the actual dividends are paid.

[11] This is not to say that the concepts of "accumulated profits" and "earnings and profits" are in every respect identical. Accumulated profits under Section 902 are computed on a year-by-year basis, while earnings and profits are computed on both a current basis and an aggregate historical basis (Section 316(a) provides that a dividend may be paid out of current earnings and profits even if there is a deficit in the historical earnings account). See generally Pet. App. 26a n.8; *H.H. Robertson Co.* v. *Commissioner*, *supra*, 59 T.C. at 78-79. But Section 902 operates properly only if the terms are interpreted using the same criteria (see Rev. Rul. 63-6, 1963-1 C.B. 126, 128), and therefore both must be determined under principles of United States tax law.

B. The Court of Appeals' Interpretation Undermines The Statutory Policy Of Providing The Same Relief From Double Taxation For Domestic Companies That Operate Through Foreign Subsidiaries As Is Provided To Those That Operate Through Foreign Branches

1. One of the major concerns that pervades the foreign tax credit provisions is the desire to provide domestic companies, like respondent, that operate their foreign businesses through separately incorporated foreign subsidiaries with the same relief from double taxation that is provided to companies that operate through unincorporated foreign branches. A foreign branch is simply a part of the larger domestic company; it is not a separate taxable entity. Therefore, all of its income earned in a foreign country is automatically income to the larger domestic company and is subject to taxation on its United States income tax return. Since 1918, the domestic company has been entitled to take a credit against its United States income tax for the foreign income taxes paid by its branch. See Revenue Act of 1918, ch. 18, § 238(a), 40 Stat. 1080. This is the "direct" credit that is now contained in Section 901 of the Code.

The "indirect" credit of Section 902 at issue here is necessary to prevent companies that operate through foreign subsidiaries from being placed at a relative disadvantage to their counterparts that operate through foreign branches. The domestic parent of a foreign subsidiary cannot take any direct credit for foreign taxes under Section 901 because it does not pay any foreign tax; rather, the tax is paid by its foreign subsidiary, which is a separate entity for tax purposes. Section 902 allows the domestic parent to take an apportioned credit for those foreign taxes as if it had paid them itself. The apportionment aspect of Section 902 is necessary to prevent companies that operate through foreign subsidiaries from gaining an advantage over their counterparts that operate through foreign branches. When the subsidiary does not distribute all of its earnings to the domestic parent, then allowing the parent a credit for the full amount of the foreign tax paid would overcompensate for the possibility of double taxation and would provide a tax benefit that is not available to companies that operate through foreign branches. Thus, the apportionment formula of Section 902 is designed to limit the allowable indirect credit to the amount of foreign tax that was paid on the earnings actually distributed to the parent. See generally *Burnet* v. *Chicago Portrait Co.*, 285 U.S. 1, 7-10 (1932).

The legislative history of the foreign tax credit provisions demonstrates Congress's fundamental and continued concern that the statute promote equality of treatment of the two forms of conducting business abroad. In connection with the 1921 legislation that introduced the term "accumulated profits" into the ratio for computing the indirect credit, a spokesman for the Treasury explained that an American corporation with a foreign subsidiary is, "economically and practically," in much the same position as a domestic business with a foreign branch and "[t]he proposal is to give this American corporation about the same credit as if conducting a branch" (*Internal Revenue: Hearings on H.R. 8245 before the Senate Comm. on Finance*, 67th Cong., 1st Sess. 389 (1921) (statement of Dr. Adams)). See also *Associated Telephone & Telegraph Co.* v. *United States*, 306 F.2d 824, 832 (2d Cir. 1962), cert. denied, 371 U.S. 950 (1963). Senator Smoot, the sponsor of the legislation, echoed these sentiments on the floor of Congress, explaining

how the mechanism of a prorated credit would operate to achieve parity of tax treatment between the two forms of operating foreign business. See 61 Cong. Rec. 7184 (1921).[12]

Subsequent amendments to the foreign tax credit provisions have also been specifically intended to further the goal of providing the same relief from pos-

[12] Senator Smoot explained the purpose of the indirect credit as follows (61 Cong. Rec. 7184 (1921)):

> This amendment extends the credit for foreign income and profits taxes paid, to a domestic corporation which owns a majority of the voting stock of a foreign subsidiary, from which subsidiary the domestic corporation receives taxable dividends.
>
> In such a case a foreign subsidiary is much like a foreign branch of an American corporation. If the American corporation owned a foreign branch, it would include the earnings or profits of such branch in its total income, but it would also be entitled to deduct from the tax based upon such income any income or profits taxes paid to foreign countries by the branch in question. Without special legislation, however, no credit can be obtained where the branch is incorporated under foreign laws.
>
> Since the foreign subsidiary may not send back to the American parent company all of its profits or earnings, it follows that the American parent company should not obtain a credit for all the income and profits taxes paid to foreign countries by the European subsidiary. The amendment in question grants only a partial or prorated credit.

Senator Pomerene, with Senator Smoot's agreement, later summarized the operation of the indirect credit as follows (*ibid.*):

> To put it in another way, certain of its profits could be passed to surplus over there, and if not distributed in dividends, then the parent company would not receive credit for that part which went to surplus.

sible double taxation for both modes of conducting foreign business. In the Revenue Act of 1962, Congress amended Section 902 and added Section 78 of the Code, which requires domestic companies to "gross up" (include in income) the foreign tax paid by the subsidiary (see note 10, *supra*). The purpose of this change was to eliminate a tax advantage enjoyed by a subsidiary operation over a branch operation. See S. Rep. No. 1881, 87th Cong., 2d Sess. 66-67 (1962); see also B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 17.11, at 17-45 to 17-47 (5th ed. 1987) (emphasis deleted) (1962 amendment "attacked * * * preference for the use of foreign subsidiaries" and "equalize[d] the treatment of foreign subsidiaries and unincorporated branches with respect to the foreign tax credit for the distributed earnings of the subsidiary").[13] In the Tax Reform Act of 1986, Congress made additional changes in the indirect credit provisions (see note 17, *infra*); one reason given for some of these changes was the desire "to provide more similar results" for branch and subsidiary operations. See S. Rep. No. 313, 99th Cong., 2d Sess. 306 (1986).

2. The decision of the court of appeals undermines this congressional policy by introducing major disparities in the treatment of companies depending upon whether they operate through subsidiaries or

[13] Under pre-1962 law, the dividend income recognized by a parent would never exceed the foreign subsidiary's *after-tax* income, while a domestic corporation operating through a branch would recognize the branch's *pre-tax* foreign income. While this advantage for subsidiaries was reduced by the *American Chicle* limitation on the indirect credit (see pp. 22-24 & note 10, *supra*), it was not completely eliminated. See S. Rep. No. 1881, *supra*, at 66-67; B. Bittker & J. Eustice, *supra*, ¶ 17.11, at 17-45 to 17-47.

branches. Foreign concepts of taxable income play no role in determining whether the earnings of a foreign branch constitute income in the hands of the domestic owner; those earnings flow directly to the owner and are recognized according to United States tax principles. As noted by Senator Smoot in explaining the 1921 amendment on the floor of the Senate (see note 12, *supra*), "[i]f the American corporation owned a foreign branch, it would include the earnings or profits of such branch in its total income" (61 Cong. Rec. 7184 (1921)). If the apportionment formula is to serve its purpose of avoiding disparities between the two kinds of business arrangements when a subsidiary distributes only a portion of its earnings, the "accumulated profits" of a foreign subsidiary must approximate the taxable income that would be recognized by the parent if it were operating as a branch. Otherwise, a distribution of all of the subsidiary's earnings and profits, which is equivalent to what always occurs in a branch operation, will not yield the same tax treatment for both forms of business. By the same token, unless the point of reference for the apportionment, *i.e.*, the total pool of earnings that potentially could be distributed by the subsidiary, is correlated with the income that would be recognized if the business were organized as a branch, the fractional credit computed under Section 902 will not apportion the credit so as to provide the same relief from double taxation to companies that operate through foreign branches and those that operate through subsidiaries. This means that the "accumulated earnings" must be computed under United States law, just like the income received by the domestic owner of a foreign branch.

The necessity for accumulated profits to be based upon principles of United States law may be illustrated by the basic example provided earlier (p. 22, *supra*), where the foreign entity pays $20 in foreign tax on profits computed at $100 under United States law and $180 under foreign law. A foreign branch would be treated as having funneled all of its profits (which would be $100 under United States law) to the domestic company, and it would receive the full $20 "direct" credit under Section 901. If the same business were conducted by a foreign subsidiary, however, and the subsidiary distributed all of its $80 in after-tax profits to the parent, computation of accumulated profits under foreign law would limit the parent to a credit for only half of the foreign taxes paid ($20 x $80/($180 - $20) = $10). This result is clearly incorrect under the statute because a domestic parent that receives a dividend distribution of all of the subsidiary's earnings should receive the same credit as if it operated its foreign business through a branch. Computing the accumulated profits of the subsidiary under United States law, conversely, would yield the correct result of the same credit available to the branch ($20 x $80/($100 - $20) = $20).

In this example, the foreign measure of income is higher than that of the United States, and therefore the result under the court of appeals' approach is to understate the credit to the disadvantage of the company operating through a subsidiary. If, as in the present case, the foreign definition of income yields a figure lower than that computed under United States law, the allowable credit under the court's approach will correspondingly be greater, thereby conferring a comparative advantage on the company

that operates through a subsidiary. In both cases, however, the court of appeals' approach subverts the clearly expressed legislative policy to avoid discrimination between the two methods of doing business abroad.

In sum, like the direct credit granted to a domestic company with a foreign branch, the indirect credit of Section 902 treats the amount of foreign tax paid as a fact. It is not concerned with how the foreign tax is computed or with the foreign income base on which the tax is imposed. It simply takes the amount of foreign tax paid and apportions it in accordance with the fractional share of the subsidiary's "accumulated profits" that is actually distributed as a dividend. To make the credit work properly, and to ensure parity of treatment with companies that operate through a foreign branch, the term "accumulated profits" in Section 902 must refer to the pool of earnings available for distribution as income to the parent—*i.e.*, earnings computed under principles of United States taxation.

C. The Court of Appeals' Decision Erroneously Overturns The Longstanding Administrative And Judicial Construction Of Section 902

1. For more than 50 years, the Treasury has uniformly interpreted the term "accumulated profits" in Section 902 and its predecessors to mean income or profits as defined under principles of United States taxation. In 1933, the Commissioner declared that "the amount of the accumulated profits" is "based as a fundamental principle upon all income of the foreign corporation available for distribution to its shareholders, *whether such profits be taxable by the foreign country or not.*" I.T. 2676, XII-1 C. B.

48, 50 (1933) (emphasis added). Accordingly, he ruled that deductions and credits allowed by foreign countries as offsets to taxable income, but not allowed as deductions under United States tax laws, do not reduce accumulated profits for purposes of the Section 902 credit because they "in no way reduce distributable income or surplus" (*id.* at 51). The inventory adjustments and accelerated depreciation that respondent's subsidiary claimed under British law fall squarely within the category of special deductions not permitted under United States law that, according to the ruling, do not decrease accumulated profits. The position of the Treasury in this case is therefore identical to the one it announced in 1933.

Since the publication of the 1933 ruling, the Treasury has consistently followed the principle that "accumulated profits" are determined by United States law. This position was embodied in a formal regulation in 1965, Treas. Reg. § 1.902-3(c)(1) (1965) (now codified at Treas. Reg. § 1.902-1(e)), which defined the accumulated profits of a foreign subsidiary for a taxable year as "the sum of (i) the *earnings and profits* of such corporation for such year, and (ii) the foreign income taxes imposed on or with respect to the gains, profits and income to which such earnings and profits are attributable" (emphasis added). "Earnings and profits" is an established term that represents the source of payments treated as dividends under Section 316 of the Code, and there is no doubt that its calculation depends upon the rules for determining United States taxable income. See pp. 18-19, *supra*; I.R.C. § 312; B. Bittker & J. Eustice, *supra*, ¶ 7.03. In Rev. Rul. 63-6, 1963-1 C.B. 126, 128, the Commissioner explained the rationale for basing the calculation of "accumulated

profits" under Section 902 upon the concept of "earnings and profits" as defined by Section 316—namely, that the term "dividends" has the same meaning in both sections and "both 'accumulated profits' and 'earnings and profits' denote the same source from which 'dividends' are paid." The Commissioner has consistently adhered to this position. See Rev. Rul. 74-310, 1974-2 C.B. 205; Rev. Rul. 87-14, 1987-1 C.B. 181; Rev. Rul. 87-72, 1987-2 C.B. 170.[14]

This Court has repeatedly held that interpretive rules and regulations promulgated by the Commissioner, "if found to 'implement the congressional

[14] There is no merit to respondent's assertion (Br. in Opp. 11) that the Treasury abandoned its position that "accumulated profits" are identified with "earnings and profits" when it declared Rev. Rul. 63-6 to be "obsolete" in Rev. Rul. 72-621, 1972-2 C.B. 651. The 1963 ruling was never revoked. It is common for a ruling to be classified as "obsolete" (*i.e.*, not controlling for future transactions) when it has become "unnecessary because the issue has been covered by regulations" (Rev. Rul. 67-6, 1967-1 C.B. 576, 577). That is precisely what occurred here. Rev. Rul. 63-6 construed Section 902 as it read before amendment by the Revenue Act of 1962. Subsequent to that statutory change, the Treasury promulgated the formal regulation described above, Treas. Reg. § 1.902-3(c)(1) (1965), interpreting the amended statute. Because that regulation embodied the substance of Rev. Rul. 63-6 and construed the new version of the statute, the ruling was declared "obsolete" under the criteria developed by the Treasury for reducing the number of outstanding rulings. Rev. Rul. 63-6 and the regulation continue to be recognized as setting forth the Treasury's position that "accumulated profits" are computed in accordance with the principles governing the calculation of earnings and profits under United States law. See S. Rep. No. 313, *supra*, at 299 n.6; *Champion International Corp.* v. *Commissioner*, 81 T.C. 424, 433 (1983); *H.H. Robertson Co.* v. *Commissioner*, 59 T.C. at 78-79.

mandate in some reasonable manner,' must be upheld." *National Muffler Dealers Assn.* v. *United States*, 440 U.S. 472, 476 (1979) (quoting *United States* v. *Cartwright*, 411 U.S. 546, 550 (1973)); see also, *e.g.*, *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948); *Commissioner* v. *Wheeler*, 324 U.S. 542, 546 (1945). Regulations carry particular force if they have been consistently followed by the Commissioner for many years, so long as they are harmonious with the governing statute. See 440 U.S. at 477; *United States* v. *Correll*, 389 U.S. 299, 305-306 (1967) (quoting *Helvering* v. *Winmill*, 305 U.S. 79, 83 (1938)) ("Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law."). Here, the regulation defining accumulated profits with reference to United States concepts of taxation reflects a position first announced by the Treasury more than 55 years ago and adhered to consistently ever since. Moreover, as the Claims Court correctly stated, "[t]he regulation is consistent with the purposes enunciated by Congress when enacting the indirect tax credit legislation" (Pet. App. 26a). Accordingly, the Treasury's longstanding interpretation of "accumulated profits" in Section 902 is entitled to substantial deference.

2. Although this established administrative position has, for the most part, not been challenged in litigation, it has been approved by the Tax Court on two occasions. *Steel Improvement & Forge Co.* v. *Commissioner*, 36 T.C. 265, 276-282 (1961), rev'd on other grounds, 314 F. 2d 96 (6th Cir. 1963), is directly in point. There, a domestic corporation re-

ceived dividends from a foreign subsidiary in 1953 and 1954 that were covered by the subsidiary's accumulated profits for the years of the distributions. The subsidiary reported a loss on its foreign tax return for a later year, however, and it carried back the loss to reduce its income for 1953 and 1954, thereby generating a refund of all the foreign tax paid for those years. For purposes of computing the parent's indirect foreign tax credit, the Commissioner recognized the refund and treated the subsidiary as having paid no creditable foreign tax in 1953 and 1954 (see I.R.C. § 905(c)). Because the loss and carryback were allowable only under the tax law of the foreign country, however, the Commissioner did not decrease the subsidiary's "accumulated profits," reasoning that they must be computed under principles of United States taxation. Thus, he continued to treat the dividends as covered by the accumulated profits of the years in which they were distributed, and, because no creditable foreign tax was paid for those years, he did not allow any foreign tax credit on the taxpayer's United States income tax returns for 1953 and 1954. The Tax Court upheld the Commissioner's position in a reviewed decision, stating that "the accumulated earnings and profits from which the dividends are paid are to be determined under American rather than foreign law" (36 T.C. at 277).

The Tax Court reaffirmed this holding in *Champion International Corp.* v. *Commissioner*, 81 T.C. 424 (1983). The foreign subsidiary in that case, unlike the subsidiary in *Steel Improvement* and respondent's subsidiary, sustained a loss that could be carried back under both United States law and the tax law of the foreign country. The question in the case was the

year in which the loss should be recognized for purposes of computing "accumulated profits." In permitting the carryback sought by the taxpayer, the Tax Court noted that "[t]he accumulated profits in the denominator [of the Section 902 fraction] represent the fund from which the dividends were paid and must be determined in accordance with U.S. law" (81 T.C. at 433; see also *id.* at 431). The court discussed *Steel Improvement* at length and specifically approved its holding (*id.* at 446-447), stating unequivocally that "[a]ccumulated profits are determined under American law rather than foreign law" (*id.* at 447).[15]

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[15] Contrary to the court of appeals' assertion (Pet. App. 7a-8a), the Tax Court in *Champion* did not misconstrue its own decision in *Steel Improvement.* In *Steel Improvement* the Tax Court ruled that "the accumulated earnings and profits from which the dividends are paid are to be determined under American rather than foreign law" (36 T.C. at 277), and it supported that ruling by reference to decisions involving the computation of earnings and profits under Section 316. The only question before the Tax Court in *Steel Improvement* was whether a loss recognized only by a foreign jurisdiction could be carried back to reduce "accumulated profits" for purposes of the Section 902 credit; therefore, the court of appeals' suggestion that the Tax Court was not interpreting Section 902 is mistaken. Rather, the Tax Court's statement in *Steel Improvement* can reasonably be understood to mean only that "accumulated profits," like earnings and profits, are determined under United States law. See Pet. App. 17a-19a. The Tax Court recognized this fact in *Champion,* as did Congress when it cited *Steel Improvement* as standing for this proposition in a committee report concerning the 1986 amendments to Section 902. See S. Rep. No. 313, *supra,* at 299 & n.6.

The court of appeals' reliance (Pet. App. 7a) on the Tax Court's criticism in *Champion* of *Pacific Gamble Robinson Co.* v. *United States,* 62-1 U.S.T.C. (CCH) ¶ 9160 (W.D.

Numerous texts and commentaries on the foreign tax credit likewise have concluded that accumulated profits must be computed under principles of United States taxation.[16] And Congress, in the course of amending the foreign tax credit provisions in other respects in 1986, explicitly noted its recognition that, under existing law, "accumulated profits * * * are generally calculated in accordance with the principles governing the calculation of earnings and profits for U.S. tax purposes" (S. Rep. No. 313, *supra*, at 299). The Senate Report cited *Steel Improve-*

Wash. Dec. 15, 1961), is equally unfounded. *Pacific Gamble* involved the same issue as *Champion*—whether a loss sustained by the foreign subsidiary that is recognized under the tax law of both the United States and the foreign country can be carried back to reduce the "accumulated profits" of an earlier year. The district court in *Pacific Gamble* denied the carryback; the Tax Court in *Champion* criticized that holding and reached the opposite conclusion (see 81 T.C. at 443 n.29). Neither of these holdings has any bearing on the issue presented here, which concerns the treatment of the 1973 loss that is allowed only by foreign law. Hence, both *Pacific Gamble* and *Champion* are fully consistent with the Commissioner's position here.

[16] See 1 E. Owens & G. Ball, *The Indirect Credit* 161-162 (1975); E. Owens, *The Foreign Tax Credit* 119-121 (1961); B. Bittker & J. Eustice, *supra*, ¶ 17.11, at 17-44 to 17-45; *Federal Income Tax Project: International Aspects of United States Income Taxation* 398 (A.L.I. 1987); Schoenfeld, *Some Definitional Problems in the Deemed Paid Foreign Tax Credit of Section 902: "Dividends" and "Accumulated Profits,"* 18 Tax L. Rev. 401, 407-421 (1963); Eigner, *The Foreign Tax Credit*, 39 Taxes 724, 729-730, 736 (1961); Mentz, *The Effect of Net Operating Losses on the Foreign Tax Credit*, 30 Tax Law. 309, 324 n.36, 333 (1977); Burda, *The Foreign Loss Carryback Dilemma: Gone But Not Forgotten*, 13 Int'l Tax J. 199, 206 (1987).

ment, Treas. Reg. § 1.902-1(e), and Rev. Rul. 63-6, *supra*, as evidencing this settled proposition (S. Rep. No. 313, *supra*, at 299 n.6).[17] See also H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 841 (1984) (for purposes of the "deemed paid" credit, "accumulated profits are essentially equivalent to earnings and profits"). Thus, the decision below clearly departs from "the generally accepted view that (E & P) and accumulated profits are computed in accordance with U.S. concepts * * *." Fuller, *Section 902 Accumulated Profits: The Federal Circuit*

[17] The 1986 Act prospectively changed the operation of the Section 902 credit to eliminate the "annualization" approach, *i.e.*, the matching of the dividend to accumulated profits on a year-by-year basis (see note 4, *supra*). See Section 1202(a) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2528. Because Congress believed that this scheme was subject to manipulation by taxpayers and also subject to other problems, it provided that retained earnings after 1986 would all go into one "pool," which would be the source of the dividends. See generally S. Rep. No. 313, *supra*, at 305-306; B. Bittker & J. Eustice, *supra*, ¶ 17.11, at 17-47 to 17-48. Congress accomplished this change by redrafting Section 902, including replacing the term "accumulated profits" with the term "post-1986 undistributed earnings." The latter term is defined as the "earnings and profits" of the foreign subsidiary accumulated in years after 1986 and computed "according to rules substantially similar to those applicable to domestic corporations" (see 26 U.S.C. 902(c)(1) (Supp. IV 1986) and 964(a)). Therefore, while Congress was not focusing on the question presented here in drafting the 1986 legislation, it is nonetheless clear that, under the new law, United States tax principles must be used in defining the subsidiary's profits to be used in the apportionment formula of Section 902. Congress manifestly believed that it was perpetuating existing law on this issue. See S. Rep. No. 313, *supra*, at 299 & n.6.

Takes a Different View in Goodyear, 17 Tax Mgmt. Int'l J. (BNA) 502, 503 (1988).

3. This established interpretation of "accumulated profits" also accords with the general principle concerning the construction of the foreign tax credit provisions that was laid down by this Court in *Biddle v. Commissioner*, 302 U.S. 573 (1938). The Court there stated that, because the subject matter of the Code is the computation of United States income tax, it should be presumed that Congress intended that "its own criteria" would be used to interpret the terms of the statute (*id.* at 578). The Court explained that this presumption could be rebutted only if "the statute, by express language or necessary implication, makes the meaning of the phrase * * * depend upon its characterization by the foreign statutes" (*ibid.*). Under this principle, the Court in *Biddle* held that the phrase "income taxes paid or accrued" in a predecessor to Section 901(b)(1) was to be interpreted in accordance with United States tax law, finding "nothing in [the statute's] language to suggest that in allowing the credit for foreign tax payments, a shifting standard was adopted by reference to foreign characterizations and classifications of tax legislation" (*id.* at 578-579).

There is similarly nothing in Section 902 to suggest that the computation of accumulated profits for purposes of the indirect credit should be made under the laws of a foreign country rather than under the laws of the United States. Under the heretofore settled rule, the prorated credit is computed solely by reference to the familiar principles of the Internal Revenue Code; the vagaries of foreign tax law play no role. The court of appeals' approach, however, would require that the court determine the taxpayer's

accumulated profits under the unfamiliar tax principles of various foreign jurisdictions, which may be difficult to ascertain and may contain concepts of profits and taxable income that are profoundly different from those of the United States. This imposition of a "shifting standard * * * adopted by reference to foreign characterizations and classifications of tax legislation" (302 U.S. at 578-579) would depart from the teaching of *Biddle* and would create troublesome and unwarranted interference with the proper administration of the statute.[18]

D. The Court Of Appeals' Interpretation Is Not Supported By Either The Plain Meaning Of The Statute Or Its Policy Of Preventing Double Taxation

1. The court of appeals relied almost entirely on what it found to be the "plain meaning" of Section

[18] It is doubtful whether there is any foreign country whose income tax laws accord with those of the United States in every respect. Thus, the court of appeals' approach could seriously burden the fair administration of the Section 902 credit no matter where a foreign subsidiary of a domestic corporation does business. Those problems could be compounded if a subsidiary earns income in, and pays taxes to, more than one foreign jurisdiction, requiring a revenue agent to be conversant with the idiosyncrasies of each system in order to identify the profits out of which a dividend is declared. In the present case, the parties stipulated to the computation of taxable income under British law, and respondent did not contend that the revenue laws of Ireland, where its subsidiary also did business (see Pet. App. 10a), differed in material respects from the tax laws of the United States. There is no assurance that the parties would agree on the vagaries of foreign law in other cases; the court of appeals' decision thus could lead to burdensome litigation over the precise contours of income, deductions, or losses under differing schemes of taxation.

902 (Pet. App. 6a), without even acknowledging the longstanding contrary administrative construction that had been approved by the Tax Court and relied upon by the Claims Court below. Its holding rests on one phrase in Section 902 read in isolation. Because the statute refers to foreign taxes paid "on or with respect to * * * accumulated profits" (§ 902 (a)(1); see also § 902(c)(1)), the court held that "accumulated profits" must be defined as the "actual basis on which the foreign sovereign assesses tax liability," *i.e.*, taxable income as computed under foreign law (Pet. App. 6a). But this reasoning, which in any event hardly represents a "plain meaning" construction, loses any semblance of force when the entire statute is examined.

The prefatory clause of Section 902(a)(1) refers to the "dividends * * * paid by such foreign corporation out of accumulated profits." Under the court of appeals' own reasoning, this language indicates that the statutory "relationship" that must not be "sever[ed]" (see Pet. App. 6a) is the one between the dividends received by the parent (and subjected to United States income taxation) and the accumulated profits out of which the dividends are paid. As we have seen (pp. 18-19, *supra*), the Code specifies that payments are treated as "dividends" to the extent that their source is "earnings and profits." Hence, this clause of Section 902 essentially identifies "accumulated profits" with "earnings and profits." Even the court of appeals recognized "the undisputed and well-settled fact that 'the determination of a foreign corporation's *earnings and profits* * * *, for purposes of the imposition of the U.S. tax, is to be made by the application of U.S. tax principles'" (Pet. App. 7a (quoting *H.H. Robertson Co. v. Commissioner*,

supra, 59 T.C. at 69)). Thus, the court of appeals' approach to parsing the statute is indeterminate; depending upon which clause of Section 902(a)(1) is examined, it points to the conclusion that "accumulated profits" are computed under United States law at least as strongly as it suggests that foreign law principles should be used.

Moreover, even if one focuses narrowly on the "taxes paid" clause on which the court of appeals relied, there is little support in the text of the statute for the court of appeals' conclusion. This is precisely the phrase that this Court construed in *American Chicle Co.* v. *United States*, *supra*. As we have explained (see pp. 22-25, *supra*), the teaching of that case is that this clause—the "taxes paid * * * on or with respect to the accumulated profits"—limits the allowable credit to the foreign tax attributable to the earnings of the subsidiary that are available for distribution as dividends in the United States. The maximum amount of the subsidiary's earnings available for distribution as a dividend depends upon the subsidiary's "earnings and profits," a figure determined under United States law. Thus, even the "taxes paid" clause, when construed in light of *American Chicle*, supports the Commissioner's position that accumulated profits are calculated under United States law.[19]

[19] The court of appeals' reliance (Pet. App 6a) on Rev. Rul. 74-310, 1974-2 C.B. 205, is misplaced. That ruling provides no support for the court's theory that the term "accumulated profits" in the "taxes paid" clause means the foreign tax base to which the foreign government actually applies its tax. Indeed, in holding that the foreign income tax paid for a given year is deemed to have been paid "on or with respect to" that year's accumulated profits as computed under United States principles even though the profits are computed dif-

It is therefore apparent that the "plain meaning" of the statute does not provide an adequate basis for the court of appeals' decision. Indeed, if any "plain meaning" can be gleaned from examination of the statute alone, it is the meaning suggested by the general principle of *Biddle* v. *Commissioner, supra*—namely, that provisions of the Internal Revenue Code governing the computation of domestic income taxes are to be interpreted in accordance with United States law in the absence of some express indication to the contrary. The correct meaning of "accumulated profits" must be derived from its context in Section 902, taking into account the purposes of the statute and the way in which the credit is designed to work. That inquiry, as we have shown, clearly demonstrates that the amount of "accumulated profits" is to be determined in accordance with United States tax law.

2. The court of appeals' belief that its interpretation would promote the statutory goal of preventing double taxation (Pet. App. 6a-7a) is similarly unfounded. The court's analysis rested in large part on assuming the answer to the question presented; once it had concluded that the credit is correctly computed by determining "accumulated profits" under foreign law, the court reasoned that the higher amount of tax that respondent would owe if United States law principles are used (see pp. 6-7 & note 5, *supra*) must reflect double taxation. The court summarized its analysis by stating that "the IRS view inflates" the

ferently under the tax law of the foreign country, the ruling implicitly rejects the theory of the court of appeals below. See 1 E. Owens & G. Ball, *The Indirect Credit* 82 (1975). Moreover, the ruling specifically incorporates the definition of accumulated profits in Treas. Reg. § 1.902-3(c)(1), which identifies accumulated profits with "earnings and profits" as determined under United States law.

amount of accumulated profits, which would yield "double taxation" because "tax payments already made to the foreign country will not be fully recoverable as tax credits" (*id.* at 6a-7a).

The court of appeals' analysis is misguided. When accumulated profits are determined under United States tax principles, the foreign taxes paid by a subsidiary in a given year remain "fully recoverable" when the profits for that year are fully distributed to the parent. That respondent's correctly computed indirect tax credit on its 1970 and 1971 tax returns is smaller than the credit that would be computed by defining accumulated profits under foreign law principles is not the result of double taxation, but rather is the necessary and appropriate consequence of the favorable tax treatment allowed to respondent's subsidiary by British law. Because British law permitted a loss and carryback to 1970 and 1971 not available under United States law, the subsidiary's profits for those years when computed under United States law were much higher than under British law, *and the subsidiary paid no tax to Britain on those additional United States profits.* Those profits computed under United States law were sufficient to cover the dividends that the subsidiary distributed in 1970 and 1971, and the Commissioner accordingly "sourced" the dividends to those profits for purposes of computing the Section 902 credit. See Pet. App. 23a-24a. Since the subsidiary paid no foreign tax on the additional "United States profits," there was no danger that those profits would be subject to double taxation when distributed as dividends includable in respondent's United States income. Rather, those profits were taxed *for the first time* as income by the United States.

Under the statutory scheme, therefore, respondent is simply not entitled to any foreign tax credit with respect to those additional United States profits—a manifestly reasonable result since its subsidiary had paid no foreign tax upon them. By contrast, respondent's position would distort the credit by treating the dividends in question as a distribution of profits earned in prior years (1968 and 1969) when the subsidiary paid higher taxes to Britain. Obviously, respondent would secure a tax advantage if it could treat the dividend as coming entirely from profits that had previously been subject to foreign tax (thus necessitating a credit on the United States return in order to avoid double taxation). Nothing in Section 902, however, entitles respondent to overlook the earnings and profits of 1970 and 1971 that were not subjected to foreign taxation. Under the governing rules of Sections 312 and 316 of the Code, the dividends received by respondent were paid out of the subsidiary's 1970 and 1971 profits; the 1968 and 1969 profits were not distributed to respondent. Thus, respondent seeks a credit for foreign taxes paid with respect to undistributed profits. Because the basic function of the statute's apportioning fraction is to grant a credit only for profits distributed as dividends to the United States parent, not for profits retained by the foreign subsidiary as surplus, the Claims Court correctly described respondent's position as seeking "a substantial windfall" that would "eviscerate the very purpose of the pro-rata credit" (Pet. App. 24a).

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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APPENDIX

The Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the years 1970 and 1971, provided in pertinent part:

§ 316. **Dividend defined.**

(a) **General rule.**

For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

§ 901. **Taxes of foreign countries and of possessions of United States.**

(a) **Allowance of credit.**

If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the applicable limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this

chapter for such taxable year. The credit shall not be allowed against the tax imposed by section 56 (relating to minimum tax for tax preferences), against the tax imposed by section 531 (relating to the tax on accumulated earnings), against the additional tax imposed for the taxable year under section 1333 (relating to war loss recoveries) or under section 1351 (relating to recoveries of foreign expropriation losses), or against the personal holding company tax imposed by section 541.

(b) **Amount allowed.**

Subject to the applicable limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) **Citizens and domestic corporations.**

In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profit taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; * * *

§ 902. **Credit for corporate stockholder in foreign corporation.**

(a) **Treatment of taxes paid by foreign corporation.**

For the purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall—

(1) to the extent such dividends are paid by such foreign corporation out of accumulated profits (as defined in subsection (c)(1)(A)) of a

year for which such foreign corporation is not a less developed country corporation, be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States on or with respect to such accumulated profits, which the amount of such dividends (determined without regard to section 78) bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes (other than those deemed paid); * * *

* * * * *

(c) **Applicable rules.**

(1) **Accumulated profits defined.**

For purposes of this section, the term "accumulated profits" means with respect to any foreign corporation—

(A) for purposes of subsections (a)(1), (b)(1)(A), and (b)(2)(A), the amount of its gains, profits, or income computed without reduction by the amount of the income, war profits, and excess profits taxes imposed on or with respect to such profits or income by any foreign country or any possession of the United States; and

* * * * *

The Secretary or his delegate shall have full power to determine from the accumulated profits of what year or years such dividends were paid, treating dividends paid in the first 60 days of any year as having been paid from the accumulated profits of the preceding year or years (un-

less to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings.

The Treasury Regulations on Income Tax (26 C.F.R.), as in effect in 1970 and 1971, provided in pertinent part:

§ 1.902-3 **Credit for domestic corporate shareholder of a foreign corporation** (after amendment by Revenue Act of 1962).

* * * * *

(c) **Determination of accumulated profits and taxes paid on or with respect thereto**—(1) First-tier corporation which is not a less developed country corporation. The accumulated profits for any taxable year of a first-tier corporation which is not a less developed country corporation, as defined in § 1.902-4, for such year shall in accordance with section 902 (c)(1)(A), be the sum of—

(i) The earnings and profits of such corporation for such year, and

(ii) The foreign income taxes imposed on or with respect to the gains, profits, and income to which such earnings and profits are attributable.

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